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The 1980 Financial Reform Act: What Will It Do?

MORGAN J. LYNGE, JR.

On 31 March 1980 President Carter signed into law the "Depository Institutions Deregulation and Monetary Control Act of 1980." This act has been described as the most far-reaching piece of banking legislation enacted since 1935. It affects virtually all financial institutions in the US, provides for major changes in the rules governing their activities, and represents a giant step towards enabling all depository institutions to operate on a "level playing field." While most of the provisions directly affect financial institutions, depositors and borrowers will also be affected. The purpose of this article is to examine the immediate and expected future impacts of this act on financial institutions, the public, and the conduct of monetary policy.

Legislative Background of the Act

Although the act passed Congress rather quickly (by legislative standards), its gestation period spans at least a decade. The financial industry is subject to a high degree of regulation which affects the structure of the industry, prices of its products, and the products which are sold. Because of the important influence of regulation the ability of the industry to adapt to a changing environment is constrained. As new financial assets are developed, as interest rates reach new highs and fluctuate widely, regulatory change is often needed to allow new activities. Pressures for change come from financial institutions, from the consumer and business customers of the institutions, and from regulators who are charged with maintaining the soundness and competitiveness of financial institutions. Additional pressures are generated by the need to maintain effective monetary policies which operate through the financial system.

These pressures for change have spawned several major inquiries into the workings and regulation of financial institutions. In 1970 the Commission on Financial Structure and Regulation (the Hunt Commission) was created to conduct a thorough analysis of the structure and regulation of financial institutions. In its 1971 report to the President the commission made a number of recommendations that would lead to greater flexibility and operating freedom for financial institutions. It stressed that all institutions competing in the same markets be allowed to do so on an equal basis.

In 1975 a separate study of financial institutions regulation was initiated by the House Committee on Banking, Currency, and Housing. This study, titled *Financial Institutions and the Nation's Economy* (the FINE study), also developed a number of recommendations that would relax regulations of financial institutions allowing greater competition.

Although there are differences between the recommendations of these two inquiries, there are many similarities. These include the removal of rate ceilings on deposits, expanded lending powers for all deposit financial institutions, similar tax treatment for all institutions, third-party payment accounts (checking accounts) for all deposit institutions, and equal reserve requirements for all financial institutions. Some of these recommendations were included in a number of bills that were prepared and debated in Congress beginning in 1973. Some

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of these bills passed one house of Congress but not the other. Some went as far as conference committees. But the net result was that no major reforms became law.

During this period of legislative nondecision, economic events were intensifying the pressures for action. Interest rates peaked at historically high levels in 1974. Since deposit rates paid by financial institutions were limited by law, disintermediation occurred. Depositors withdrew funds from passbook savings accounts whose rates of interest were restricted by the law to 5 to 5¼ percent and purchased Treasury bills or money market mutual fund shares yielding much higher and unrestricted rates. In 1978 regulatory authorities designed the money market certificate of deposit with a ceiling rate tied to a Treasury bill rate. The idea was to create a deposit on which the rate of interest paid was more closely related to market rates of interest.

The market test of this new instrument was close at hand. In 1979 and 1980 interest rates rose to levels above those reached in 1974. Even with a minimum denomination of $10,000 the new money market certificates proved wildly popular. By May 1980 these certificates accounted for over 37 percent of the sources of funds for savings and loan associations. This experiment helped hone the public's desire for financial instruments whose yields were not restrained by ceilings.

Another trend that continued during the 1970s was an erosion in Federal Reserve membership by commercial banks. Banks with state charters have the option of joining the Federal Reserve (the Fed). Benefits of membership include access to borrowing directly from the Fed and use of Fed services such as check clearing and wire transfers. The primary cost of membership is being subject to reserve requirements set by the Fed. In recent years the number of banks belonging to the Fed has declined, indicating that for many the costs of membership outweigh the benefits. This membership "problem," from the point of view of the Fed, impacts on its ability to carry out monetary policy. If the Fed chooses to alter the reserve requirements of member banks to attempt to achieve some economic goal, a declining number of member banks reduces the impact of such an action. Thus the Fed has argued for some time for a solution to the membership problem in order to improve the effectiveness of monetary policy.

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A 1979 decision by the courts also applied pressure for action. In that year the court declared certain activities of financial institutions — share drafts at credit unions, automatic transfer accounts at commercial banks, and remote service facilities by savings and loan associations — to be illegal, since they were not specifically authorized by Congress. The court delayed its ban on such activities until 31 December 1979 to give Congress time to pass authorizing legislation. At year-end 1979 Congress passed a bill allowing these activities on a temporary basis until 31 March 1980. The permanent authorization of these three activities is a part of the Financial Reform Act and helped provide pressure for timely passage of the act.

Provisions of the Act

As the culmination of the lengthy period of study and the increasing pressures for action, the Financial Reform Act was passed and signed into law. As the full title of the act indicates, its provisions can be grouped under two major headings: (1) depository institutions deregulation, and (2) monetary control. The "Exhibit" lists some of the major provisions of the act under each of these headings.

The deregulation provisions generally increase the scope of deposit-taking, lending, and pricing activities of all deposit institutions. They move toward a regulatory environment that allows credit unions, savings and loan

EXHIBIT

SUMMARY OF FINANCIAL REFORM ACT

Deregulation provisions	*Effective date*
(1) Permits nationwide NOW accounts for all deposit institutions	31 December 1980
(2) Phases out deposit interest rate ceilings	Over a 6-year period
(3) Expands the lending powers of credit unions, savings and loan associations, and mutual savings banks	1 September 1980
(4) Eliminates state usury ceilings on first mortgage loans for residences. Raises loan rate ceiling for credit union loans	31 March 1980
(5) Increases level of federally insured deposits	31 March 1980
Monetary control provisions	
(1) Establishes reserve requirements for transactions accounts at all deposit institutions. Removes reserve requirements on personal savings accounts	Four-year phase-in for member banks; 8-year phase-in for nonmember banks and other deposit institutions, both beginning 1 September 1980
(2) Allows borrowing from the Fed for all deposit institutions	31 March 1980
(3) Makes Fed services available to all deposit institutions on a fee basis	1 September 1981

associations, mutual savings banks, and commercial banks to engage in similar activities.

(1) Initiates nationwide NOW accounts. Negotiable order of withdrawal (NOW) accounts are essentially interest-bearing checking accounts. These accounts have previously been allowed in the New England states, New York, and New Jersey. Expansion nationwide provides the opportunity for nonbank deposit institutions to get into the checking account business for individuals and nonprofit organizations. Individuals will now have the opportunity to earn interest on their checking account balances. Since these accounts can be used to make payments, the definition of money (M1B definition) has been revised to include NOW account balances.

(2) Eliminates deposit interest rate ceilings. Banks (since the 1930s) and other deposit institutions (since the 1960s) have faced maximum rates of interest that they can pay on savings and time deposit accounts. Originally imposed to restrict destructive competition among banks, these ceilings in the last 15 years have exacerbated the phenomenon of disintermediation. The act creates a Depository Institutions Deregulation Committee and charges it with the task of phasing out these ceilings over a six-year period. Implicit in this provision is the view that these ceilings discourage saving and create inequities for depositors, especially those with modest savings. This committee has already implemented several changes, including an increase in the ceiling rates for six-month money-market certificates and the 30-month small-saver certificates.

(3) Expands lending powers. The nonbank depository financial institutions — credit unions, mutual savings banks, and savings and loan associations — operate under an array of restrictions on the kinds of loans and investments they can make. These restrictions have caused these institutions to become specialized in consumer loans (credit unions) and mortgage loans (mutual savings banks and savings and loan associations). The act broadens the scope of loans that can be made by these institutions. Federal credit unions can now make residential real estate loans; federal mutual savings banks can make certain commercial loans; savings and loan associations are given higher loan ceilings, expanded investment authority, and are allowed to issue credit cards and establish trust activities.

(4) Eliminates usury ceilings. The laws in various states limiting the rate charged on residential mortgage loans are preempted. States may reimpose these ceilings by 1 April 1983. State usury ceilings on certain business and agricultural loans are also temporarily raised. The credit union loan rate ceiling of 12 percent is raised to 15 percent, and increased flexibility in raising it further is granted.

(5) Increases deposit insurance level. As has been well publicized, the act increases deposit insurance from $40,000 to $100,000 per account. This results in about 70 percent of the dollar value of aggregate deposits being insured; previously about 63 percent was insured.

The second category of provisions is oriented toward improving the Fed's ability to carry out monetary policy, and makes some changes in access to Federal Reserve services.

(1) Establishes new reserve requirements. This provision addresses the membership problem for the Federal Reserve. A reserve requirement will be uniformly applied to all transactions accounts at all deposit institutions, whether Fed members or not. Transactions accounts include checking, NOW, telephone transfer and automatic transfer accounts, and share drafts. The reserve requirement for all institutions with these accounts will be 3 percent for that portion below $25 million and 12 percent for the portion above $25 million. The Fed has the authority to vary the 12 percent requirement between 8 and 14 percent. In addition all deposit institutions must maintain reserves of 3 percent (this can be varied by the Fed between 0 and 9 percent) against their nonpersonal time deposits. There are no reserve requirements on personal time and savings deposits. The act also gives the Fed authority, under "extraordinary circumstances," to exceed the stated ranges of reserve requirements and to impose reserve requirements on other types of liabilities.

These new reserve requirements will require substantial adjustments by most institutions. For current Fed member banks, the new reserve requirements will result in a lower level of required reserves. For these banks reserve requirements will be phased down over a four-year period to the new levels. For nonmember banks and all nonbank deposit institutions holding reservable deposits, the new requirements will be phased in over an eight-year period.

(2) Extends borrowing from the Fed. Before passage of the act, only member banks could borrow at the Fed's discount window. Beginning immediately any deposit institution subject to the new reserve requirement will have the same borrowing privilege as did member banks.

(3) Establishes fees for Fed services. As was the case for discount window borrowing prior to the act, only member banks could utilize the services made available by the Fed for no charge — including coin and currency services, check clearing and collection, wire transfers, and automated clearinghouse services. The act requires the Fed to establish a schedule of fees that it will charge for its services. These services will, beginning 1 September 1981, be made available to all deposit institutions on a fee basis.

As can be seen, these three provisions taken together "solve" the Fed membership problem by making it irrelevant. All deposit institutions must hold uniformly calculated required reserves, and can borrow from or buy services from the Fed. Thus these costs and benefits are no longer unique to membership in the Fed.

The Financial Reform Act contains a number of other provisions not highlighted here. The purpose of some of these other provisions are, again, deregulation by simplifying truth-in-lending disclosures and simplifying reporting and overlapping regulations of the several regulatory agencies.

Impact of the Act: Who and What?

The 1980 act alters many of the rules of the game for financial institutions. The result will be the development of a new game plan for many of them. These changed operating strategies will present new opportunities and problems for depositors and borrowers. Finally, the Fed's conduct of monetary policy could change in light of its new powers. Although some of the following is speculative, here is a look at how the act may influence some of the major participating groups.

The *nonbank financial institutions* now have the opportunity that some have wanted and others have feared for some time: the chance to compete on a more equal basis with commercial banks for the total financial business of individuals. Savings and loan associations, mutual savings banks, and credit unions may become the family financial centers of the future. Because they can offer transaction accounts (NOWs) and share drafts, credit cards, trust services, and consumer and mortgage loans, they no longer need to take a back seat to the "full service" commercial bank. As deposit ceilings are removed, they can also compete more effectively for deposit sources of funds. Freedom to pay higher rates on deposits and to charge higher rates on loans will permit operations to continue even during periods of high interest rates as long as a credit demand continues. This expanded operating field comes at the cost of maintaining required reserves (on transaction and nonpersonal time accounts) and the loss of the ¼ percent differential advantage over commercial banks in deposit rates. While the reserve burden may not be great, overall costs of doing business will be somewhat higher, and vary more with market interest rates. This more competitive environment will require effective management and, most likely, the disappearance of some institutions through failure or merger.

These institutions will be under tighter scrutiny and control by the Fed than they have been accustomed to. If the Fed alters reserve requirements frequently to achieve monetary policy objectives, nonbank financial institutions will have to adapt to this outside influence on their operating strategies. In summary, nonbank financial institutions will gain both the opportunities and problems of a freer, more competitive environment along with the rights and responsibilities formerly belonging to Fed member commercial banks.

The *commercial banks* will also find their rules changed somewhat. Non-Fed member banks are now facing federally imposed reserve requirements, although the entire new reserve requirement structure has generally lower requirements than the old structure applied to member banks. The reserve requirement burden is likely to be greater for these banks than for the nonbanks because of their higher levels of transactions accounts and nonpersonal time deposits. Nonmember banks also gain access to discount window borrowing and Fed services although the latter will be on a fee basis. Member banks will benefit from the less burdensome reserve requirement structure but must begin paying fees for Fed services. All banks will be allowed to offer interest-bearing NOW accounts, but this is a less attractive authority, since they already offer transactions accounts (checking accounts) on which no interest is paid. All banks will benefit from the removal of loan rate ceilings and the loss of the ¼ percentage point advantage in deposit rates previously held by nonbanks. This latter change has been a sore point for bankers for over a decade.

Many smaller retail-oriented banks will face increased competition from nonbank financial institutions for household business in the loan and deposit markets. Because of the new rules some banks may switch their emphasis from consumer business to servicing business customers where the transaction account advantage remains. The correspondent banking business may also be changed. Those larger, member banks who used Fed services without fees and "sold" those services to smaller banks will face a change in their cost calculus. Depending on the level of the fees established for Fed services, some of the services provided by correspondent banks may be priced out of the market. Respondent banks will have to reassess their correspondent relationships, and correspondent banks may have to alter their prices or means of pricing of correspondent services. Certainly a large portion of the correspondent structure, involving services and products not available from the Fed, will remain.

The *public* will be faced with changes in their dealings with financial institutions. The authorization of NOW accounts provide individuals with an alternative, or at least a complement, to the checking account. In the New England area, where NOW accounts have been offered since the early 1970s, at least two-thirds of the financial institutions have chosen to offer them. Public acceptance has grown with over 70 households out of every 100 having a NOW account in Massachusetts. Competitive pressures will likely result in many banks and nonbank financial institutions offering this type of account. However, along with receiving interest on transaction accounts consumers may be required to pay for the check clearing and record keeping associated with these accounts. Following the establishment of fees by the Fed, financial institutions may require explicit payments for services received by their account holders. While it is right that one should pay for what is received, this new charge may diminish the attractiveness of receiving interest on transactions accounts.

The removal of deposit rate ceilings will allow depositors to shop around for the highest rate paid. This competitiveness in deposit rates may raise the structure of deposit rates paid by financial institutions, and this increased cost will no doubt be reflected in higher loan rates charged. It has long been argued that deposit rate ceilings penalize small depositors, with a subsidy being received by borrowers. In an environment with no deposit or loan rate ceilings this subsidy will no longer exist. Individuals will have at their disposal a wider range of products and services available from nonbank institutions that were formerly obtainable only from commercial banks. This larger array of choices will increase the convenience of obtaining financial services for this group of customers.

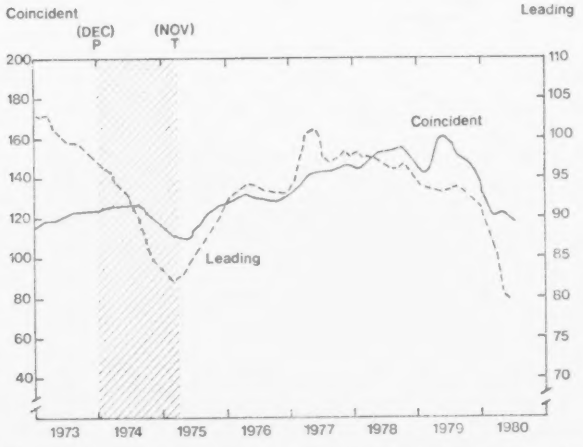
Finally, the *Federal Reserve* will be affected by the

Financial Reform Act. The power of the Fed to influence financial institutions through reserve requirements will be extended to over 40,000 firms from about 5,600 now. If the Fed is willing to make frequent, small adjustments in these requirement percentages, the behavior of many institutions can be influenced. In addition the information-reporting requirement accompanying the reserve requirements can give the Fed much more accurate and timely data on movements in the money stock. In short, the ability of the Fed to control money growth will be improved. Still, the appropriateness of the goals for money growth that the Fed sets, and the vigor with which the Fed exercises its power will determine the successfulness of monetary policy.

Conclusions

The Depository Institutions Deregulation and Monetary Control Act of 1980 has introduced changes that will continue to be phased in over the next six to eight years. Therefore, its impact will be felt in an evolutionary and gradual way. The financial institutions of the late 1980s, partly as a result of this act, should be more diverse with less emphasis on one type of lending, and more competitive with one another, especially for the business of consumers. The distinctions between commercial banks and the other financial institutions, distinctions created more by regulation than economics, will be diminished. Deposit and loan customers of these institutions will receive and pay interest rates that more closely resemble market rates of interest at all times. If all goes well, the financial institutions industry will be characterized by vigorous, competitive, sound institutions efficiently providing financial products to their customers. If this is the result of the 1980 act, the time spent waiting for its reforms will have been worth it.

Illinois Economic Indicators



Note: *P* and *T* designate peaks and troughs of the business cycle for the US as defined by the National Bureau of Economic Research.
Bureau of Economic and Business Research

The coincident indicator declined by 0.9 percent in July. Although this is not welcome news, this month's drop is well below the 1.4 percent skid during the previous month. The primary factor contributing to the downturn appears to have been the number of employees in the nonagricultural sector, which fell by 0.2 percent over the past month on a seasonally adjusted basis.

On a far more pleasant note, the leading indicator turned upward by 0.3 percent. The increase was led by a sharp rebound in both building permits and the layoff rate in manufacturing. Although the overall use in the indicator is less robust than might be desired, the numbers lend some support to the contention that the end of the recession in Illinois is in sight.

Illinois Business Indexes

Item	July 1980	June 1980	May 1980	April 1980	July 1979
Leading indicator (1969=100)	79.5	79.2	80.1	82.5	94.0
Coincident indicator (1969=100)	119.3	120.4	122.14	121.2	159.3
Employment-manufacturing (in thousands)	1,179.4	1,207.2	1,213.4	1,200.4	1,282.5
Average weekly hours-manufacturing	38.7	39.3	39.4	39.8	40.5
Weekly earnings-manufacturing	$313.08	$314.01	$311.26	$310.44	$798.12
Layoff rate-Chicago	1.3	1.6	1.6	1.3	0.4
Help wanted advertising-Chicago (1967=100)[1]	68.0	69.0	67.0	74.0	117.0
Help wanted advertising-St. Louis (1967=100)[1]	52.0	56.0	58.0	62.0	85.0
Ordinary life insurance sales (in millions)	$1,504	$1,581	$1,648	$1,632	$1,476
Retail sales (in millions)	n.a.	3,781	4,037	3,731	3,736
Coal production (in thousands of tons)	4,070	5,246	5,585	5,664	3,661
Petroleum production (in thousands of barrels)	1,880	1,820	1,929	1,921	1,871
Vendor performance (percent)	30.8	25.9	30.2	42.5	60.0
Building permits (in thousands)					
Residential housing units	2.85	1.70	1.15	.94	3.74
Value of residential housing	$107,752	$71,587	$52,525	$49,642	$62,921
Value of nonresidential housing					
Industrial buildings	$20,400	$28,095	$25,756	$22,819	$55,019
Office, banks, and professional buildings	$58,029	$34,404	$25,861	$36,516	$57,941
Stores and other mercantile buildings	$21,281	$32,622	$34,482	$29,827	$36,932
Other	$30,708	$41,004	$40,168	$27,560	$98,707
Consumer price index					
North Central US	-	134.7	-	131.3	-
North Central/population more than 4,000,000	-	136.7	-	133.2	-
North Central/population 385,000 to 1,250,000	-	134.4	-	130.9	-
North Central/population 75,000 to 385,000	-	131.9	-	128.9	-
North Central/population less than 75,000	-	128.7	-	131.9	-
Chicago	246.8	248.2	243.1	240.1	217.4
St. Louis	245.0	-	241.8	-	216.9
Prices received by farmers	121	110	105	104	120

	1980:I	1979:IV	1979:III	1979:II	1979:I
Personal income (in millions)	$116,977	$114,130	$112,234	$108,287	$106,555
Total labor and proprietors' income by place of work					
By type					
Wage and salary disbursements	74,587	72,834	72,281	70,122	69,622
Other labor income	7,925	7,622	7,535	7,216	7,027
Proprietors' income	7,236	7,620	7,327	6,962	6,653
Farm	1,713	2,126	1,977	1,789	1,464
Nonfarm	5,522	5,493	5,350	5,172	5,189
By industry					
Farm	2,053	2,449	2,296	2,101	1,762
Nonfarm	87,695	85,627	84,846	82,199	81,540
Private	75,721	73,881	73,301	71,308	70,885
Ag. serv., for., fish., and other	204	207	204	197	187
Mining	997	980	917	919	881
Construction	5,105	4,929	4,794	4,918	5,097
Manufacturing	25,571	24,592	25,607	24,808	24,929
Nondurable goods	7,936	8,228	7,963	7,710	7,696
Durable goods	17,636	16,364	17,643	17,098	17,233
Transportation and public utilities	7,346	7,206	6,923	6,757	6,682
Wholesale trade	7,085	7,111	6,866	6,737	6,522
Retail trade	8,186	8,131	7,998	7,842	7,897
Finance, insurance, and real estate	6,252	6,031	5,787	5,394	5,097
Services	14,974	14,695	14,206	13,736	13,593
Government and government enterprises	11,974	11,746	11,546	10,891	10,655
Federal, civilian	1,936	1,926	1,864	1,832	1,816
Federal, military	572	552	513	515	505
State and local	9,465	9,269	9,169	8,544	8,334
Income by place of work					
Wage and salary disbursements	74,587	72,834	72,281	70,122	69,622
Farm	301	286	283	277	266
Ag. serv., for., fish., and other	128	130	128	122	116
Mining	761	750	703	707	680
Construction	4,223	4,032	3,907	4,004	4,120
Manufacturing	22,023	21,217	22,125	21,477	21,637
Nondurable goods	6,899	7,165	6,945	6,737	6,742
Durable goods	15,125	14,051	15,180	14,740	14,895
Transportation and public utilities	6,113	6,072	5,844	5,709	5,660
Wholesale trade	6,166	6,200	5,995	5,896	5,715
Retail trade	6,910	6,878	6,768	6,655	6,708
Finance, insurance, and real estate	4,921	4,767	4,555	4,253	4,010
Services	11,313	11,106	10,766	10,447	10,359
Government and government enterprise	11,615	11,397	11,206	10,575	10,351
Federal, civilian	1,846	1,836	1,778	1,749	1,735
Federal, military	572	552	513	515	505
State and local	9,197	9,008	8,914	8,311	8,111

Sources available upon request. [1]Source: The Conference Board, Help Wanted Advertising, July 1980.
n.a. not available.

Comparative Economic Data for Selected Illinois Cities, July 1980

	Building permits (000)		Electric power consumption (000,000 kwh)		Postal receipts (000)		Employment (000)		Estimated work force unemployed (percent)	
	July 1980	% change from July 1979	July 1980	% change from July 1979	July 1980	% change from July 1979	July 1980	% change from July 1979	July 1980	July 1979
ILLINOIS	$76,349[a]	n.a.	3,505.5[a]	-3.8	$50,316[a]	+11.1	5,566.0	-3.2	9.9	5.1
NORTHERN ILLINOIS										
Chicago	$42,588	-71.4	1,638.8	-8.3	37,679	+8.7	3,178.9[b]	+0.3	9.1[b]	4.9[b]
Aurora	1,161	-83.6	109.7	-5.7	634	+2.9	36.4	-1.9	10.6	4.4
Elgin	1,766	-14.4	101.5	-6.1	695	+6.6	28.1	+0.4	10.1	4.7
Joliet	1,317	-25.6	369.7	-5.9	351	+11.1	34.8[b]	-2.0	16.0[b]	7.8[b]
Kankakee	1,311	-55.8	84.7[c]	+15.6	323	+63.1	37.5	-5.0	14.3	8.3
Rock Island-Moline	4,233	+33.8	132.3[d]	+0.3	1,912	+74.3	102.8[e]	-6.2	9.7[e]	4.4[e]
Rockford	2,482	-77.5	162.1	-6.8	956	+7.4	121.0[b]	-6.2	12.1[b]	4.9[b]
CENTRAL ILLINOIS										
Bloomington-Normal	2,991	-68.0	56.2	+6.6	994	+9.1	53.7[b]	-2.2	7.1[b]	3.1[b]
Champaign-Urbana	1,072	-28.9	57.7	+2.5	710	+22.4	73.5[b]	-2.4	6.7[b]	4.2[b]
Danville	3,912	+357.5	104.4	+124.0	223	+15.4	16.2	-11.0	17.5	7.9
Decatur	1,215	-44.3	134.4	+5.9	531	+11.1	53.2[b]	-3.3	15.9[b]	6.2[b]
Galesburg	265	-95.4	29.7[c]	-2.3	179	+35.6	13.0	-13.9	18.9	7.1
Peoria	4,146	-89.3	202.8	+0.9	1,696	+35.1	161.0[b]	-5.0	9.3[b]	4.3[b]
Quincy	2,281	+101.2	41.8	-2.8	261	+14.5	18.0	-5.2	12.5	6.0
Springfield	3,120	-81.8	131.6	+4.1	2,024	-6.2	92.5[b]	+1.8	8.6[b]	5.1[b]
SOUTHERN ILLINOIS										
East St. Louis	n.a.	n.a.	20.7	-21.0	224	+33.3	21.6	-6.1	15.1	10.1
Alton	1,389	286.9	56.9	-32.4	154	+12.4	13.5	-6.2	15.3	6.7
Belleville	602	-58.6	31.9	-0.9	400	+11.7	17.1	-5.5	14.4	9.2
Carbondale-Murphysboro	498	-81.3	38.6	4.6	370	+31.7	10.6[f]	-4.5	9.3[f]	6.4[f]

[a]Total for cities listed. [b]Data for Standard Metropolitan Statistical Area. [c]Includes immediately surrounding territory. [d]Includes East Moline. [e]Illinois portion of Davenport-Rock Island Moline SMSA. [f]Data for city of Carbondale. n.a. not available.

Recovery Without Cure

It has become fashionable to assert that the economy has begun to recover. Confidence of renewed strength is nurtured by a turnaround in consumer purchases, an improvement in labor markets, and a tightening in credit markets. Most important, however, confidence is based on hope — and the proclivity of Americans to read long-term significance into short-term shifts.

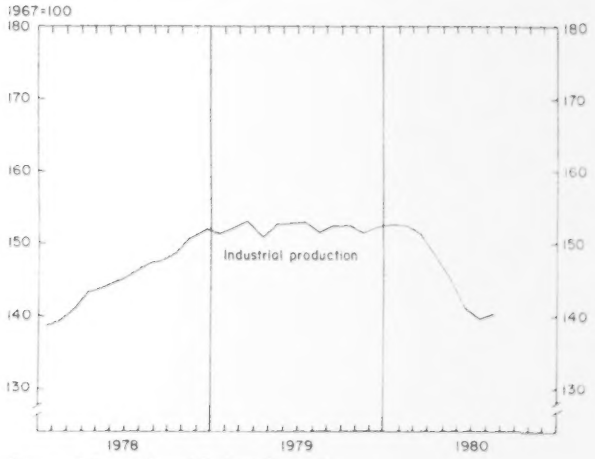
Notwithstanding the respite from the marked economic decline that characterized the spring and early summer, prudence suggests that our attention should not be diverted from the major problems facing the economy. The economy has not grown, on balance, for more than a year and a half, and it is operating substantially below capacity. Productivity has been virtually unchanged for much of the past decade. Within this milieu of persistent weakness, inflation has become a dominant problem. Whatever the character of the recent or current improvement, the economy continues to face serious problems.

Output Stabilizes?

Preliminary estimates of the nation's output indicate little change during the July–September quarter. Revised estimates of real GNP for the April–June quarter -- that is, gross national product adjusted for inflation have concentrated the downturn into that time frame. As a result, the third-quarter performance looks good by comparison. Analysts have been able to seize upon the lessening in the *rate* of decline as evidence that recovery is at hand. As time unfolds, it may turn out that such a conclusion was appropriate. But that history has yet to be written.

The major evidence of renewed strength may be found in industrial production and in housing. The Index of Industrial Production — a measure of output of mines, factories, and utilities — rose 0.5 percent in August, according to preliminary estimates. Although the increase is welcome, it should be pointed out that such a gain is smaller than typical month-to-month revisions in the data. For example, the July statistic was revised upward from 138.8 (1967 = 100) to 139.8, an increase of 0.7 percent. Since January, industrial output has fallen at a 13.2 percent annual rate.

Industrial Production



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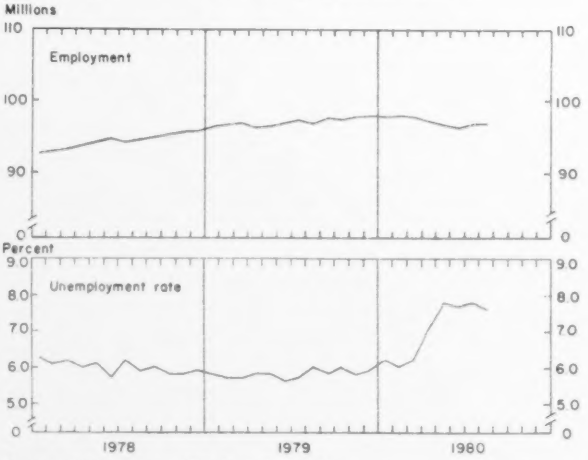
Employment and Unemployment Rate



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Housing has rebounded from its dismal performance early this year. In the past three months housing starts averaged just under 1.3 million units (at an annual rate), up about one-third from the preceding three months. In turn, the gains in housing were reflected in the strengthening in production, as rising output of household goods has been a major factor in improved industrial output. Notwithstanding recent increases, housing starts in 1980 are running substantially below their year-earlier pace.

Spending Expands

Employment has risen at nearly a 3 percent rate since June, reversing a four-month decline. Gains in employment are an aspect of the strengthening in production. Reflecting the growth in employment, income increases have accelerated. Since June personal income has expanded at a 15 percent annual rate; by comparison, in the preceding half-year income grew at about a 6 percent rate.

Unemployment has stabilized since May, following sharp increases in April and May. During the early months of the year unemployment averaged about 6 percent of the labor force; then, during a two-month period jumped to just under 8 percent. By mid-August, however, unemployment had drifted to 7.6 percent of the work force.

Consumer spending has strengthened. Households have responded to improvements in employment and

income by stepping up their purchases. Following a four-month decline, since May retail sales have expanded at nearly a 30 percent annual rate. Moreover, the rise in sales has been *real*. That is, the physical volume of retail purchases has expanded. In 1979, retail sales rose 8.6 percent; but prices rose even more, and real retail sales declined.

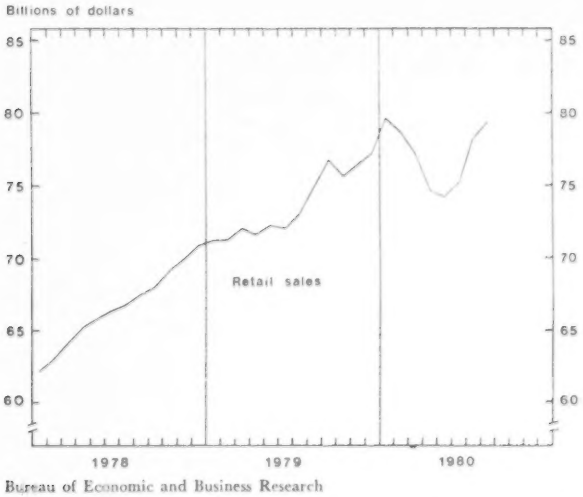
Capital spending by businesses is expected to show an 8.7 percent increase during 1980. But prices of capital equipment are expected to rise even more rapidly. As a result, *real* capital expenditures are expected to register a small decline. In 1979 real capital spending was 6.1 percent greater than in the preceding year.

Inflation Moderates?

There is an impression that the rate of inflation has moderated in recent months. The probable explanation for this impression is that measured price changes since April have been markedly lower than they had been during the preceding winter months. For example, since April consumer prices have risen at about an 8 percent annual rate; from December to April they rose at a 16.6 percent rate.

It is plausible to believe that nothing has happened to the rate of inflation, despite gyrations in month-to-month statistics. Inflation last winter was probably overstated; inflation since April is probably understated. The *core*, or underlying, rate of inflation remains within or near the 10-12 percent range. It is likely that *measured* inflation will accelerate.

Retail Sales



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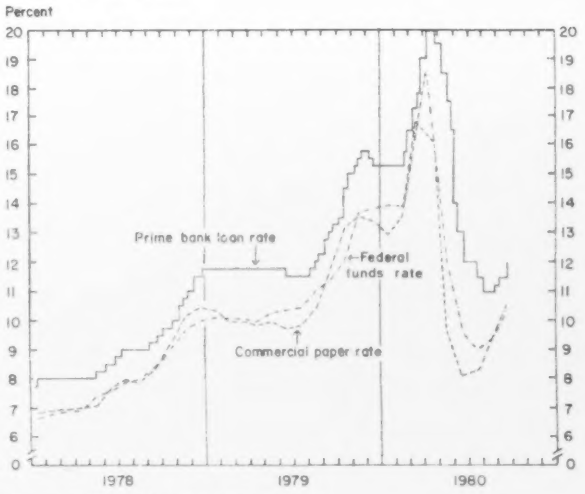
Interest Rates



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Credit Tightens and Money Eases

Interest rates have moved upward since June. Following sharp declines from March to June, interest rates have again bolted upward. Even so, they remain well below levels reached earlier this year.

The prime rate — that is, the interest rate banks charge to their most credit-worthy borrowers — declined from 20 percent in mid-April to 11 percent in late August and early July. Since then the prime rate has again moved above 12 percent. Movements in the prime rate are responsive to changes in the cost of funds to banks. To an important extent banks cover their needs for marginal funds by borrowing on the federal funds market and by selling 90-day certificates of deposit. Since June the cost of funds to banks has risen more than two percentage points.

Increasing credit demands have driven interest rates higher. Borrowing by businesses (at large reporting banks) has risen at nearly a 16 percent rate since mid-May. Such borrowing had declined from March to late May.

Monetary actions have been expansive during the period that interest rates have been rising. Since late April the money supply (M1A) has risen at more than a 10 percent annual rate. The money supply had declined during the period when interest rates were falling. It is often the case that monetary growth accelerates when interest rates rise, and decelerates when interest rates are falling. These patterns reflect the Federal Reserve's proclivity to moderate, or limit, interest rate movements — notwithstanding their October 1979 announcement that they would, henceforth, avoid such behavior.

WILLIAM R. BRYAN

The New Financial Reporting for the Effects of Changing Prices

RICHARD E. ZIEGLER

The accounting profession has moved toward handling the effects of inflation on financial statements. With its adoption of Financial Accounting Standard No. 33, the Financial Accounting Standards Board (FASB), the private-sector body that sets accounting rules, took the first step to augment the basic financial statements to reflect the impact of changing prices. Many users of financial statements have understood the need to consider the impact of changing prices in their interpretation of the financial reports of an enterprise. For others, the significance of the impact of changing prices may not have been fully comprehended until quantitative information on the effects was directly reported in the financial statements. Effective for fiscal years ending on or after 25 December 1979, the statement requires that an estimated 1,200 publicly held companies disclose supplementary information in their annual reports concerning the impact of changing prices.

Recognizing that there is no universally accepted accounting solution to reporting changing prices, the FASB has taken an experimental approach. Two different sets of disclosures — one for current cost information and another for constant dollar information — are required. The Consumer Price Index for urban consumers has been selected as the basis for making the constant dollar restatement. The statement does not modify the existing measurement concepts used to prepare the primary financial statements, and the required supplementary disclosures are not intended to address issues other than those arising from changing prices.

For many companies, the effects of the restatements have not been insignificant. As one example, General Electric Company reported $1.41 billion in profits last year. Adjusted for general inflation, that profit would be $1.06 billion. The adjustment for current costs results in a profit of $986 million. Examples of the impact on selected other companies appear in Table 1.

The statement does not require a comprehensive restatement of the financial statements. Rather, the requirements are limited to measuring and reporting the effects of changing prices of inventory, property, plant and equipment, cost of goods sold, and depreciation expense. Specific guidance as to what is encompassed in each of these categories of accounts is provided in the statement. For many companies, these are the accounts for which the impact of changing prices is greatest. No adjustments are required to other revenues, expenses, gains, or losses.

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Table 1. Effect of Price Changes on Reported Profits (1979 Income in Millions of Dollars)

	As reported in primary statements	Restated in current dollars	Restated to current cost
Alcoa	$ 505	$ 292	$ 280
Armco	221	118	97
Burroughs	306	193	345
Ford	1,169	372	213
General Motors	2,893	1,776	1,803
W. R. Grace	223	100	83
Xerox	563	345	428

The disclosure requirements encompass both the current year and a five-year history. For the year being reported, the disclosures are (1) historical cost income from continuing operations; (2) constant dollar income from continuing operations; (3) current cost income from continuing operations; (4) purchasing power gain (or loss) on net monetary items; (5) net increase (decrease) in the current cost of inventories and property, plant and equipment, net of general price inflation; and (6) current cost of inventory and property, plant and equipment at the end of the current fiscal year. The reporting requirement for current cost information is effective for annual reports beginning in 1980.

The current cost information required under Statement 33 differs somewhat from the replacement cost information formerly required by the Securities and Exchange Commission (SEC) under Accounting Series Release (ASR) 190. Under Statement 33, the current cost of an asset is the lowest current "buying price or production cost of an asset of the same age and in the same condition as the asset owned." Replacement cost, as used in the SEC's ASR 190 was defined as the lowest cost of obtaining "a new asset of equivalent operating or productive capability." Although the two cost concepts differ, the measurement of a given resource could be the same under either approach.

The disclosure requirements for the five-year summary encompass much of the information that is to be reported for each current year. One of the additional requirements is to report the effect on "net assets" (that is, shareholders' equity) of the restatements for both the constant dollar and current cost.

At its option, the enterprise may prepare its constant dollar and current cost disclosures on the basis of a comprehensive restatement of the financial statements, rather than restating only the items required under Statement 33.

An illustration of one format that may be used by companies that are subject to these disclosure requirements appears as Table 2. A commentary follows for each of the new disclosures, indicated by ( ), that is required.

TABLE 2. Statement of Income From Continuing Operations Adjusted for Changing Prices For the Year Ended 31 December 1980 (In (000s) of Dollars)

	As reported in the primary statements	Adjusted for general inflation	Adjusted for changes in specific prices (current costs)
Net sales and other operating revenues	$253,000	$253,000	$253,000
Cost of goods sold	197,000	204,384	205,408
Depreciation and amortization expense	10,000	14,130	19,500
Other operating expense	20,835	20,835	20,835
Interest expense	7,165	7,165	7,165
Provision for income taxes	9,000	9,000	9,000
	244,000	255,514	261,908
Income (loss) from continuing operations	$ 9,000 (A)	$ (2,514) (B)	$ (8,908) (C)
Gain from decline in purchasing power of net amounts owed		$ 7,729	$ 7,729 (D)
Increase in specific prices (current cost) of inventories and property, plant, and equipment held during the year[a]			$ 24,608
Effect of increase in general price level			18,959
Excess of increase in specific prices over increase in the general price level			$ 5,649 (E)

Source: Financial Accounting Standard No. 33, page 33.

[a]At 31 December 1980 current cost of inventory was $65,700 and current cost of property, plant, and equipment, net of accumulated depreciation was $85,100.

Item (A) discloses the income from continuing operations (as opposed to the "bottom line," net income) as reported in the traditional, historic-cost-based, financial statements. It is repeated here for purposes of highlighting the comparisons. For example, if at the beginning of the year, an enterprise purchased $1,000 in inventory and later sold it for $1,500, the cost of goods sold would be $1,000 and the measure of income would be $500.

Item (B) contains the income (loss) determined by restating the historic dollars of specified income statement accounts (cost of goods sold and depreciation), as defined in the statement, to an average-of-the-year dollar for the year being reported. Continuing the foregoing example, if the general price level had increased by 10 percent during the year, the cost of goods sold under the constant dollar concept would be $1,100. That amount would have the same purchasing power as $1,000 at the start of the period. If the inventory were sold for $1,500, income would be measured at $400.

Two aspects of the constant dollar restatement procedure are apparent. It does not represent a departure from the historic cost basis of recording transactions. The restatement simply restates past years' transactions into dollars with the same purchasing power as today's. Nor does the amount shown for the constant dollar restatement attempt to reflect current prices. That value may have changed in a different direction from that of the general price level change. Constant dollar restatement is intended only to make the measurement unit used in historic-cost-based financial reporting more comparable over time.

Item (C) represents the operating income (loss) determined by restating the specified items in the traditional income statement for the current cost of those items. This requires identification of the assets consumed and specific determination of their current cost. Suppose that, at the time of its sale, the inventory in the previous example was determined to have a current cost of $1,200. If the selling price of the inventory is $1,500, income would be measured at $300.

The use of current cost represents a departure from the use of historic cost in financial reporting. The original transaction price is no longer relevant; instead, it is the physical object or attribute that is relevant. The restatement is based on the current cost of acquiring the same service potential as was embodied by the asset owned. Of course, as in this example, current cost and replacement cost may be the same. It is in costing property, plant, and equipment that differences are likely to occur.

Item (D) discloses the net monetary gain or loss arising from holding monetary assets and liabilities during a period of general inflation. In this example, the amount reported represents a gain from a decline in the purchasing power of dollars required to pay a net "debtor" position. This arises when a company has an excess of monetary liabilities over monetary assets. The amount reported for this item is not included in determining the operating income under either form of restatement.

Monetary items are those that, by their nature, already are stated in current dollars and, therefore, require no restatement. Examples are cash and accounts receivable, accounts payable, and long-term obligations payable in a fixed sum. The rationale for the disclosure of net monetary gain or loss is that a company loses (gains) purchasing power from holding monetary assets

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(liabilities) during a period when the general price level is rising.

Item (E) discloses the increase or decrease in the current cost amounts of inventory and property, plant, and equipment. The change in the current cost is represented by the difference between the measures of these assets at their "entry dates" and "exit dates" for the year. Entry date corresponds to the beginning of the year or the date of acquisition, whichever is applicable; an analogous definition applies to exit dates. The information contained in this disclosure is synonymous with the more widely used term "holding gains or losses." Holding gains and losses also are excluded from the computation of net operating income.

Item (F) contains the current cost of those assets for which restatement is required on a current-cost basis. For inventories, this means current cost or recoverable amount, if lower. Similarly, property, plant, and equipment is measured at current cost or lower recoverable amount of the assets' remaining service potential.

Critics have charged that requiring two types of disclosures under Statement 33 will result in confusion. But it is because of lack of consensus among financial statement users that Statement 33 deals with the issue of changing prices in two ways. The measurement and reporting of the effect of general inflation (the constant dollar restatement) on the purchasing power of the money invested in the enterprise by its owners (either directly or by forgoing distributions of earnings) is desired by some financial statement users. Their rationale is that "earnings" have not accrued to a firm unless the purchasing power of the invested capital has been maintained. This is a response to the belief that conventional accounting measurements have failed to capture the erosion of business profits and invested capital that has been caused by inflation.

Advocates of the second approach, the use of current costs in financial reporting, do not disagree with the rationale offered for revising the traditional financial statements. However, it is their belief that inflation affects different enterprises in different ways, and utilizing an index of general inflation does not provide adequate information about its effects on a specific business. While the current cost model also is based on the notion of maintaining the capital of a business, "capital" is viewed as the operating capacity of the firm. It is the current cost required to purchase or produce the specific goods that is believed to be relevant in measuring business income and investment. They point out that changes in capital investment, such as a reduction in operating capacity, could occur without showing up in the financial statements prepared under the constant dollar model.

Critics also contend that the failure to require a comprehensive restatement of all financial statements under either constant dollar or current cost information reduces the usefulness of the information. Some believe that purchasing power gains and losses arising from general inflation are a very real element of operating income and should not be excluded. Similar comments are made relating to holding gains and losses under the current cost approach. Other practical flaws have been identified.

In preparing Statement 33, the FASB indicated its awareness of the potential impact of the statement on economic policy objectives. Their deliberations related directly to an important national economy policy issue, that of the measurement of capital formation and its corollary, productivity. The constant dollar model is based on the notion of maintaining purchasing power of invested capital, while the current cost model is based on maintaining operating capacity. Since the statement reflects both views on the issue of how to report the effects of changing prices, the information presented does provide an opportunity for experimentation and study of the usefulness of the two types of information.

The phenomenon of changing prices is worldwide. Proposals for both price-level reporting and current-value reporting are undergoing development and testing in other countries. Preparers and users of financial reports have not yet reached a consensus on the general, practical usefulness of either form of information. It seems unlikely that a consensus can be reached until further experience has been gained with the use of both types of information in a systematic, practical way. The requirements of Statement 33 will be the subject of review by the FASB on an ongoing basis. Changes will be made as evidence is accumulated both here and in other countries.